The Financial Crisis and the Real Economy


In 2008, a severe economic crisis broke out that included a collapse in the financial sector as well as a “Great Recession” in the so-called real sector of the economy (producing ordinary goods and services). This crisis originated in the United States, but quickly spread to most of the global economy. While the acute stage of the crisis, during 2008-09, has passed, the fallout persists five years later.

In the fall of 2008, all of the biggest banks in the United States faced bankruptcy and were bailed out by the taxpayers. The real sector of the economy declined from the first quarter of 2008 through the second quarter of 2009, with gross domestic product (GDP) dropping by 4.7% and the unemployment rate rising by 5.6 percentage points to reach 10.0%. By all measures, the Great Recession of 2008-09 was the most severe of any since the Great Depression of the 1930s (apart from a sharp but brief post-World War II “readjustment” as the federal government dramatically cut back spending at war’s end).

Both the financial and real-sector dimensions of the current crisis are rooted in a speculative “bubble” that arose in the housing sector of the U.S. economy starting around 2002. By the summer of 2007, housing prices (corrected for inflation) had risen by 70% since 1995. Yet, since 2002, the real value of home rents had been flat. By 2006, the ratio of the Housing Price Index to the Homeowners Equivalent Rent had risen sharply to an all-time high of nearly 170, compared to 110 in 1995. This is clear evidence of a huge asset bubble in the U.S. housing market. This bubble created an estimated $8 trillion in inflated new wealth, which was about 38% of the total housing wealth of $21 trillion at its peak in 2007. When this bubble started to collapse, it set the stage for both a financial crisis and a recession in the real economy.

There are two ways in which a collapsing housing bubble affects the real economy. First, there is a downward “wealth effect” on housing investment and consumer spending. The collapse of housing prices led to a sharp drop in residential investment. In 2007 residential investment declined by 18.7% and in 2008 by 23.9%. Falling home values also caused a reduction in consumer spending, which at some 70% of GDP is a much larger part of the economy than residential investment. Since 2002, American households, pressed by stagnating or declining wages, had been borrowing against their homes to get funds for consumer spending. One study estimated that during 2004-06, Americans took $840 billion per year from their home equity through borrowing and capital gains from the sale of housing. This was almost 10% of disposable personal income in the United States.

As the housing bubble burst, people could no longer supplement their income with funds borrowed against their homes, which led to a large drop in consumer spending, at a rate of 3.8% per year in the third quarter of 2008. This happened before the financial crisis had begun to affect consumer spending. As the $8 trillion of inflated home value disappeared, it produced a big downward impact on the economy. Dean Baker, co-director of the Center for Economic and
Policy Research (CEPR) and a respected analyst of the financial crisis, estimated the total effect of the collapsing housing bubble to be a decline of between 3.1% and 7.0% of GDP.

Second, the collapse of the bubble also affects business investment in new plant and equipment. Business fixed investment fell for ten consecutive calendar quarters over two and half years starting in the second half of 2007, reaching a 28.9% annual rate of decrease in the first quarter of 2009, after which the rate of decline gradually slowed. The bubble-propelled and debt-financed expansions of 1991-2000 and 2001-2007 both produced a growing amount of productive capacity, relative to ordinary income. As the Great Recession developed, industry found it had substantial excess productive capacity, with the industrial capacity utilization rate falling to just 66.9% in June 2009. As a result, the incentive for business investment has been depressed in the following years. In the previous recession in the United States, in 2001 after the collapse of a stock-market bubble, business fixed investment fell for two consecutive years, and at an accelerating rate, for this reason.

Capitalism and Structural Crises

Every form of capitalism has contradictions that eventually bring about a structural crisis of that form of capitalism. In the 1970s, the system of state-regulated capitalism, having produced rapid growth and high profits for a few decades, stopped working effectively and went into structural crisis. The predominant form of capitalism changed to the “neoliberal” form, which means a type of capitalism in which the role of the market expands greatly while the state, as well as other non-market institutions such as trade unions, play a more limited role in the economy.

It now appears that neoliberal capitalism can no longer work effectively to promote economic expansion and has entered a structural crisis of its own. The high and rising inequality generated by neoliberal capitalism means that the majority of the population has insufficient income to buy the growing output of the economy without relying on an unsustainable buildup of household debt. The deregulated financial system of neoliberal capitalism is inherently unstable, as we saw so clearly in the fall of 2008.

From the late 1940s to 1973, a regulated form of capitalism predominated across the world, including in the United States. Regulated capitalism in the U.S. included extensive government regulation of business and finance, regulation of the macroeconomy (aimed partly at achieving a relatively low unemployment rate), social programs that amounted to a modest welfare state, a significant role for trade unions in setting wages and working conditions through collective bargaining, restrained competition between big corporations, and trade and capital flows regulated by governments and international institutions.

The shift to neoliberal capitalism in the United States involved the deregulation of business and finance, the renunciation of active government macroeconomic policy aimed at keeping unemployment low, sharply reduced social programs, a big business and government attack against labor unions, unrestrained (“cutthroat”) competition among large corporations, and relatively free movement of goods, services, and capital across national boundaries. This neoliberal transformation of capitalism was relatively thorough in the United States, the United
Kingdom, and in international financial institutions such as the International Monetary Fund and World Bank.

Responses to the Crisis

When the structural crisis of neoliberal capitalism began in the fall of 2008, the reigning free-market ideology, which held that everyone should sink or swim based on their own efforts, was suddenly forgotten—at least for the rich and powerful. Congress was pressured into appropriating $700 billion for the Troubled Assets Relief Program to bail out the big banks and other financial institutions. However, while millions of workers lost their jobs and millions of homeowners faced foreclosure, the government did little to help them, passing a job creation bill in February 2009 that was much too small to stop the job losses and a mortgage relief bill that helped very few homeowners. This began to undermine the legitimacy of the previously dominant free-market ideology. A swell of anger arose, directed at the bankers who were seen as causing the economic crisis.

In the summer of 2009, the powers that be—policy analysts, politicians, the mass media—were able to shift the discourse by pointing to the growing federal budget deficit. From 2007 to 2009 the federal deficit jumped from 1.2% of GDP to 10.1% of GDP. This jump was primarily caused by the economic crisis itself, as rising unemployment and declining incomes meant lower tax revenues, while spending on social programs automatically increased.

Deficit “hawks” warned that the problem facing society was not 25 million unemployed workers but the “spendthrift state” and especially all those “overpaid” government employees and their “powerful unions.” Their call for “austerity” diverted attention from the bankers, who had caused the crisis. After being bailed out courtesy of the taxpayers, the banks emerged more powerful than ever and have been able to largely defang the mild Dodd-Frank bank regulatory bill passed in the aftermath of the financial crisis in 2010.

Since 2009, the U.S. economy has expanded, but very sluggishly, at 2.1% per year through the first quarter of 2013. The unemployment rate declined gradually to 7.3% in September 2013, but the ratio of employment to the working age population has not recovered, stuck at 58 to 59% compared to over 63% in 2007—showing that many workers have given up looking for work. At the rate of job creation over the past year, the economy will not reach a 6.5% unemployment rate until 2021, according to one projection. Although the sluggish recovery calls for increased public spending, the deficit hawks have prevailed so far and blocked any such measures, despite the fact that the deficit has declined as a percentage of GDP every year since 2009, as the economy has gradually expanded.

The rich have been doing well. In the recovery thus far, from 2009-2012, the richest 1% have captured 95% of the income gains in the United States, leaving only 5% of total income gains for the remaining 99%. Median household income in June 2013 was still below its level at the lowest point of the Great Recession in June 2009. The rate of profit of the nonfinancial corporate business sector fell sharply in 2008-09, but it bounced back almost to its pre-crisis level by 2011. However, the continuing structural crisis is reflected in the failure of capital accumulation—the
rate of increase in the stock of capital goods—to recover to a normal rate despite the recovery in the rate of profit.

If history is any guide, the current crisis will, like past structural crises, result in major economic restructuring during the coming years. However, the outcome of this restructuring process is not pre-determined. So far, austerity advocates have blocked any move toward economic restructuring that might actually address the real problems of the economy.

However, it is still early in the struggle over the response to the economic crisis. We can fight for changes that would benefit the majority rather than the bankers—to assist troubled workers and troubled households rather than just (the owners of) troubled assets. One measure worth fighting for would address the problems of the millions of people who are unable to make the payments on their mortgages. The government should pass an emergency bill to ease mortgage terms to reflect the declining values of homes and the declining economy. This would impose a one-time loss on the financial institutions that invested in the risky new mortgage-based securities, but it would also make it easier to know the value of the mortgage-backed securities, eliminating a source of great uncertainty in the financial system.

A second policy would have the federal government act as employer of last resort, offering a job at a living wage to anyone who cannot find work in the private sector. The federal government would provide the financing, while the jobs could be created by state and local governments, in such areas as infrastructure maintenance and improvement, education, and green technology. Such a policy would have the side benefit of putting pressure on the private sector to pay a living wage.

A third measure would address the problems of the financial system. The financial crisis taught the important lesson that banks and other financial institutions are not ordinary private companies. If General Mills loses money, or even goes bankrupt, it harms its shareholders and workers—but its competitors gain. But if a major bank lose money and are in danger of going under, this threatens the entire financial system, and with it the economy as a whole.

The obvious conclusion is that the financial sector should not be operated on a profit-and-loss basis. Instead, it should become part of the public sector, operated to serve the public interest. If banks, which are granted the power to create our money supply, and whose credit is essential to the welfare of the entire public, were made public institutions, then public-policy aims could guide their actions. They could be directed to stay away from speculative activities and instead make loans for socially valuable purposes. This would include steering credit into renewable-energy technologies, fuel-efficient vehicles, low-cost housing, and other good purposes. An advantage of public ownership of the banks over another cycle of government regulation of private banks is that re-regulated private banks can simply press for the elimination of the regulations—as they did successfully starting in the early 1980s.

The ongoing economic crisis has exposed the high-flying financial operators for what they always were—thieves who got rich without doing anything productive. This has also exposed their fallacious free-market ideology. This is a promising time, then, to build popular movements that can fight for progressive changes in our economy.